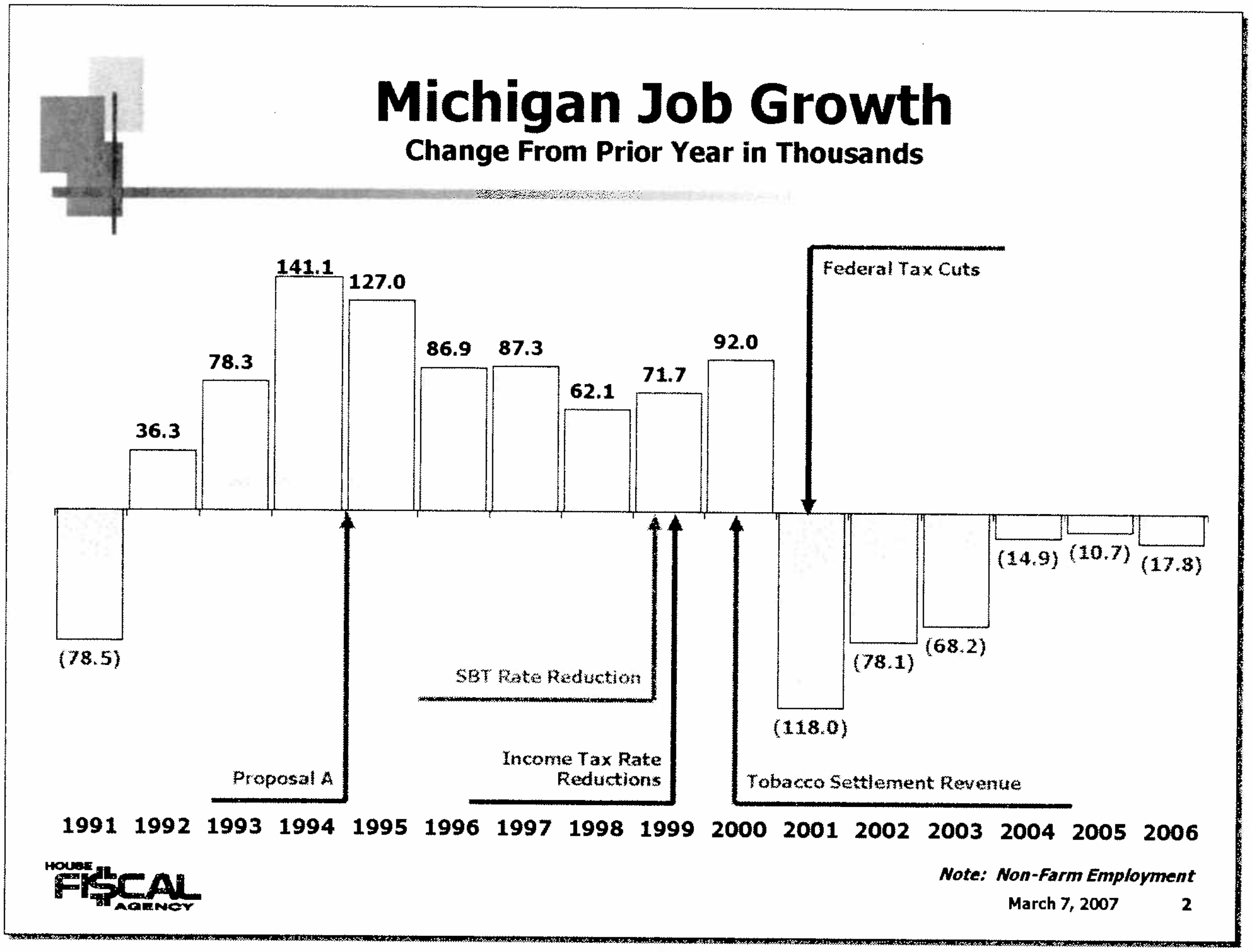
Michigan
Revenue and Economics

House Appropriations Committee
House Tax Policy Committee

Joint Meeting

HOUSE FISCAL AGENCY
Mitchell E. Bean, Director

March 7, 2007



Before Proposal A:

- Economy expanding and creating jobs
- Decade's strongest annual job growth
- State revenue growing
- Extra revenue made Proposal A possible

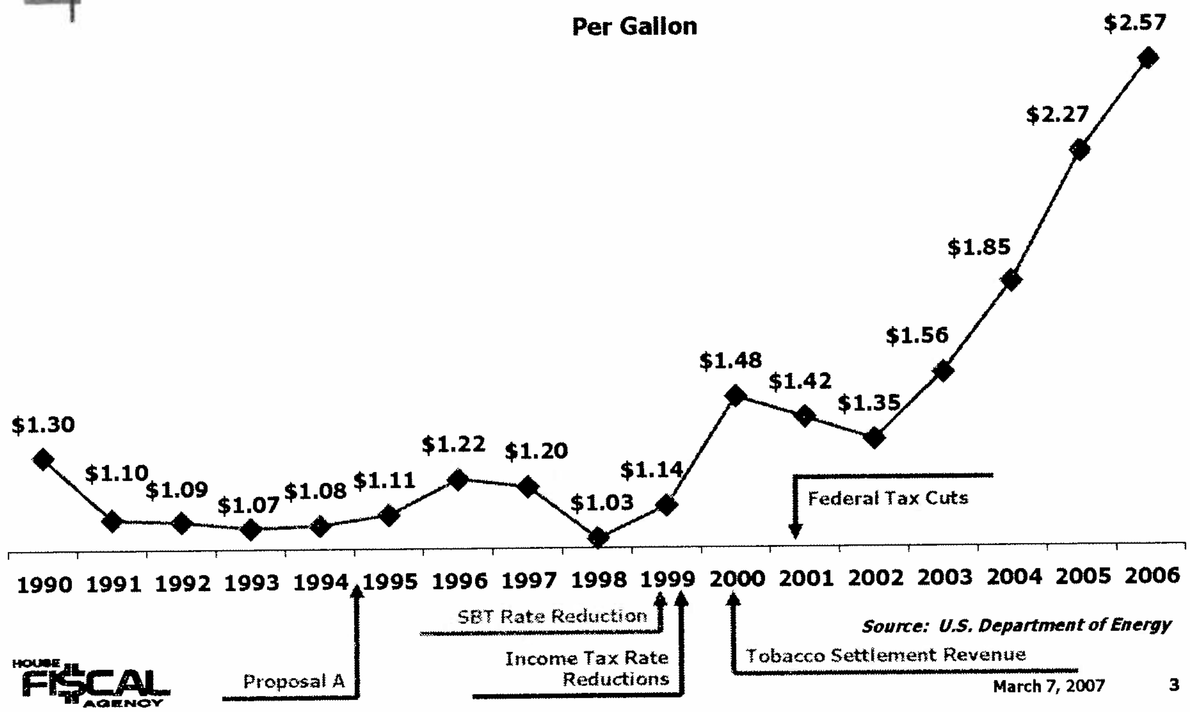
1990s state tax cuts:

- Enabled by
    - Strong job growth
    - Strong revenue growth
    - New revenue source
- No significant cut to state services

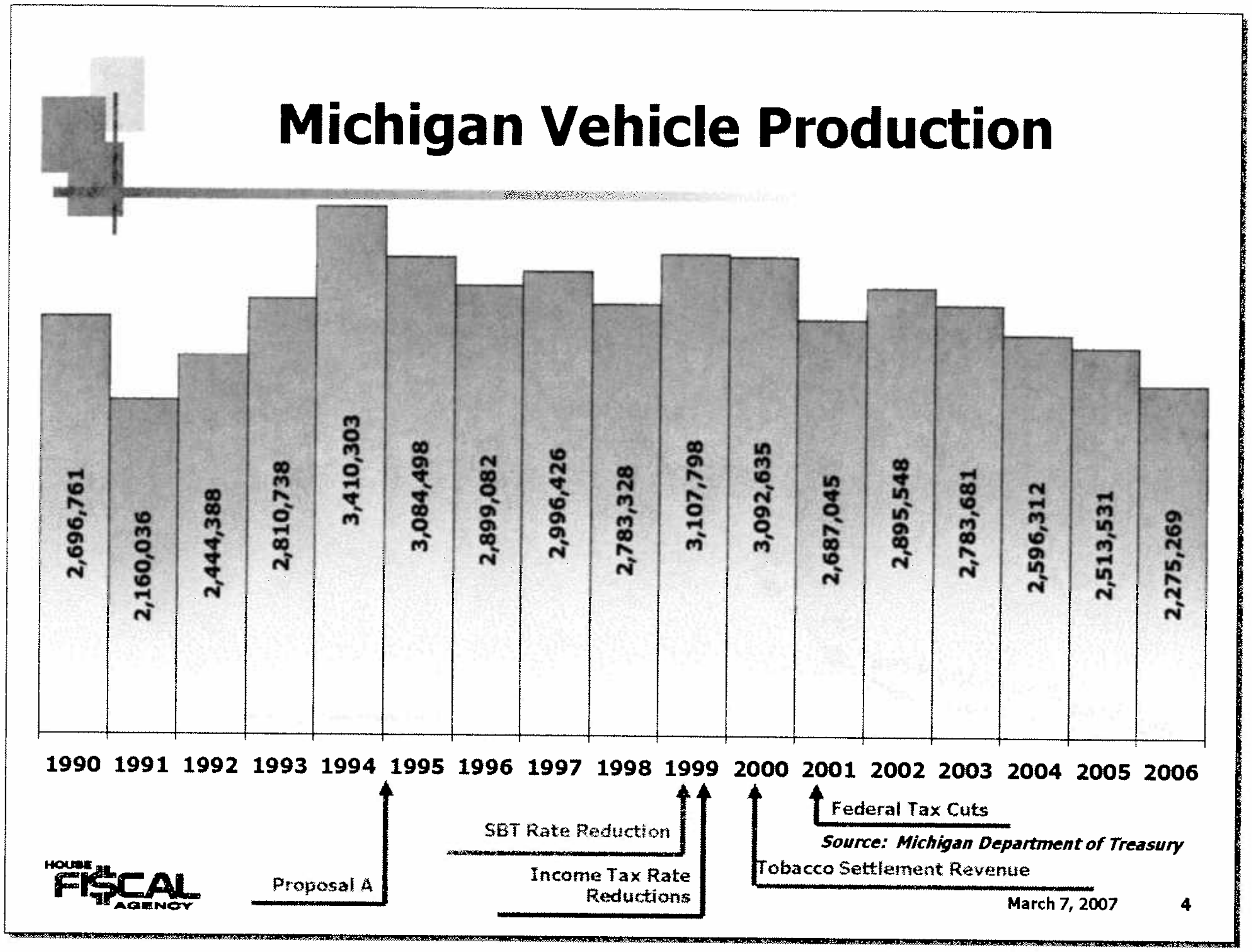
Federal tax cuts (2001 through 2004):

- Bigger than any cuts the state has done
- Had no negative impact on state services
- Did not lead to job growth

U.S. Gasoline Prices



Source: U.S. Department of Energy



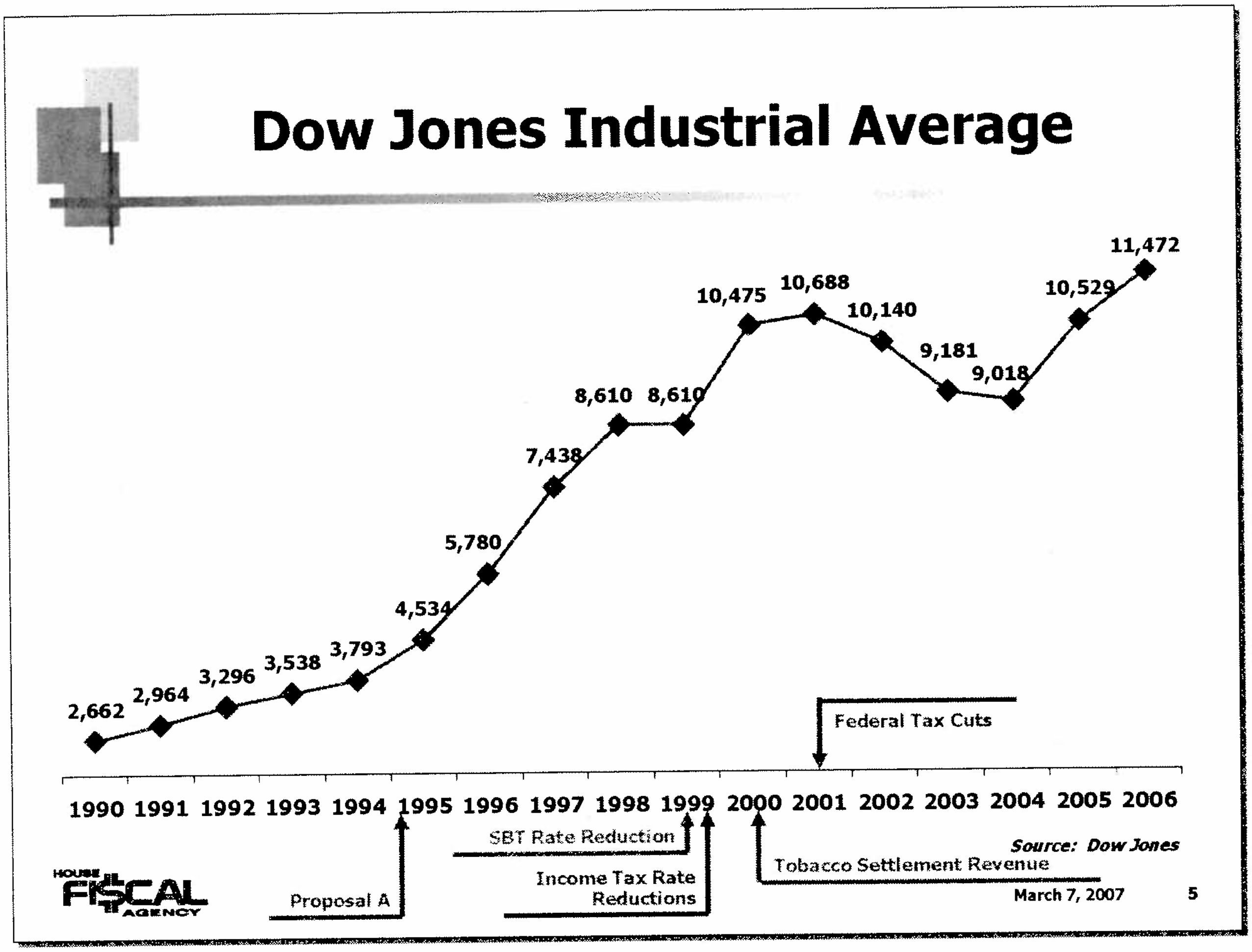
1990s:

- **Domestic auto manufacturing**
  - **Enjoyed a competitive advantage (SUVs, Mini-vans, trucks)**
  - **Low gas prices led to increased demand**
  - **Increased its demand for skilled labor**

2000 to 2006:

- **Gasoline prices ↑ from $1.48 to $2.57**
- **Michigan auto manufacturing production ↓ from 3.1 million units to 2.3 million units**

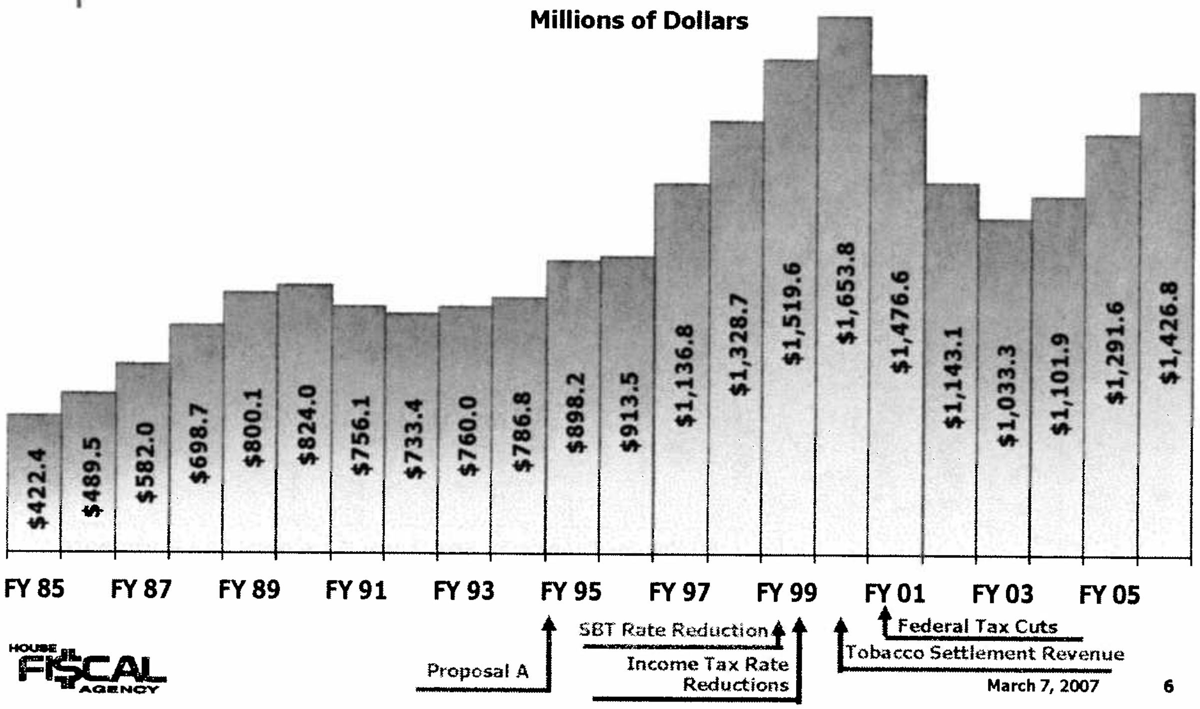
Total vehicle sales driven by national economy—not state tax policy



Strong income tax growth due largely to capital gains

Tech bubble burst in 2001; income tax revenue declined

Michigan Quarterly and Annual Income Tax Payments



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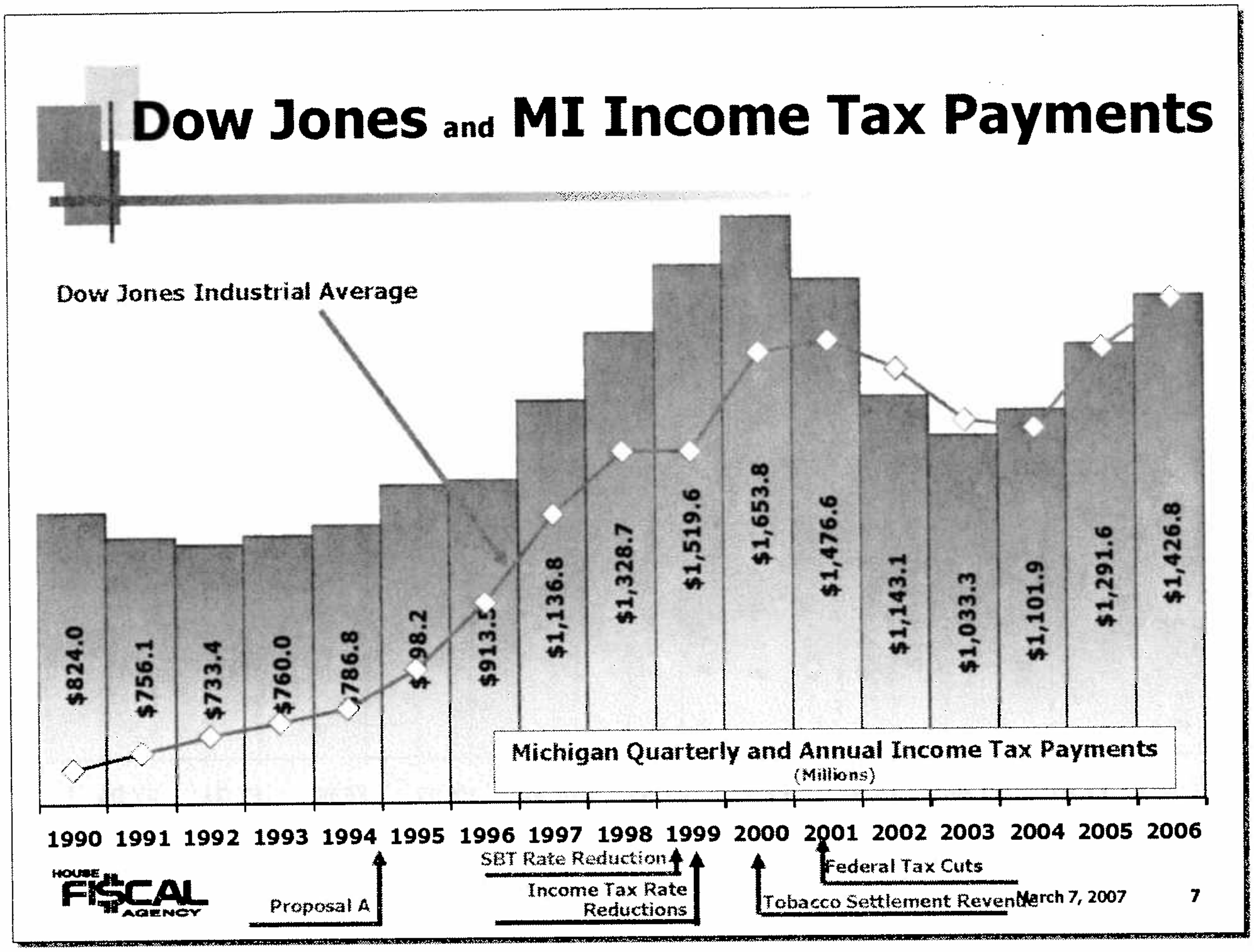
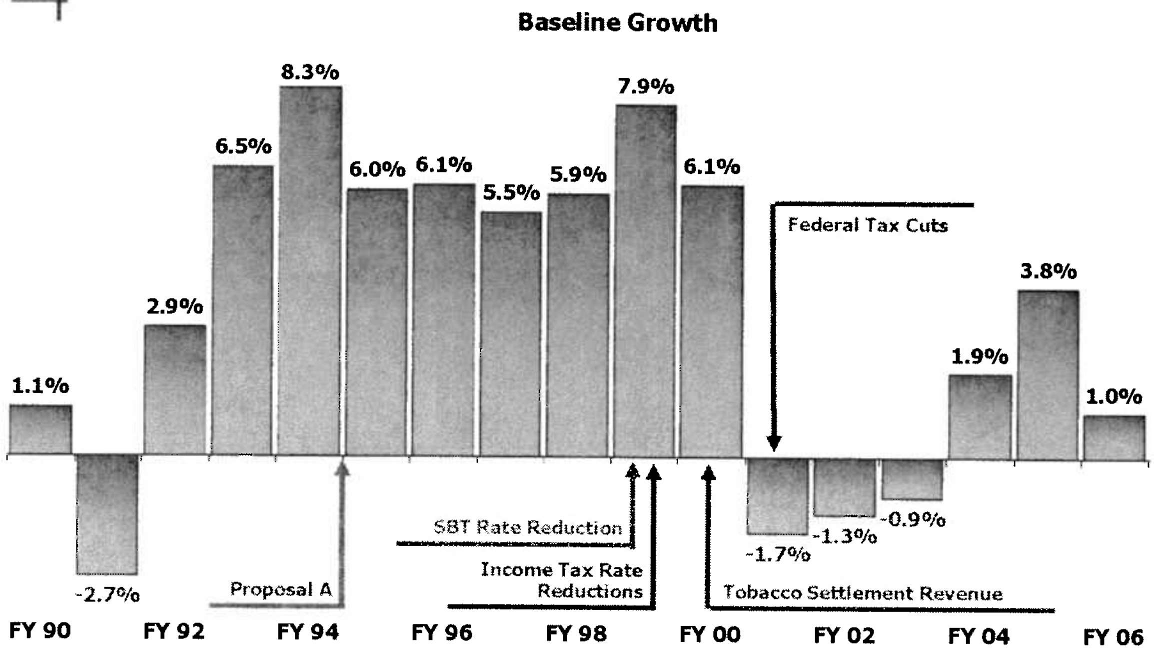
Income tax collections increased from $786.8 million in 1994 to $1,519.6 million in 1999

Approximately $500 million per year of increase from capital gains



Strong stock market had an important impact on revenue growth

GF/GP + School Aid Fund Revenue



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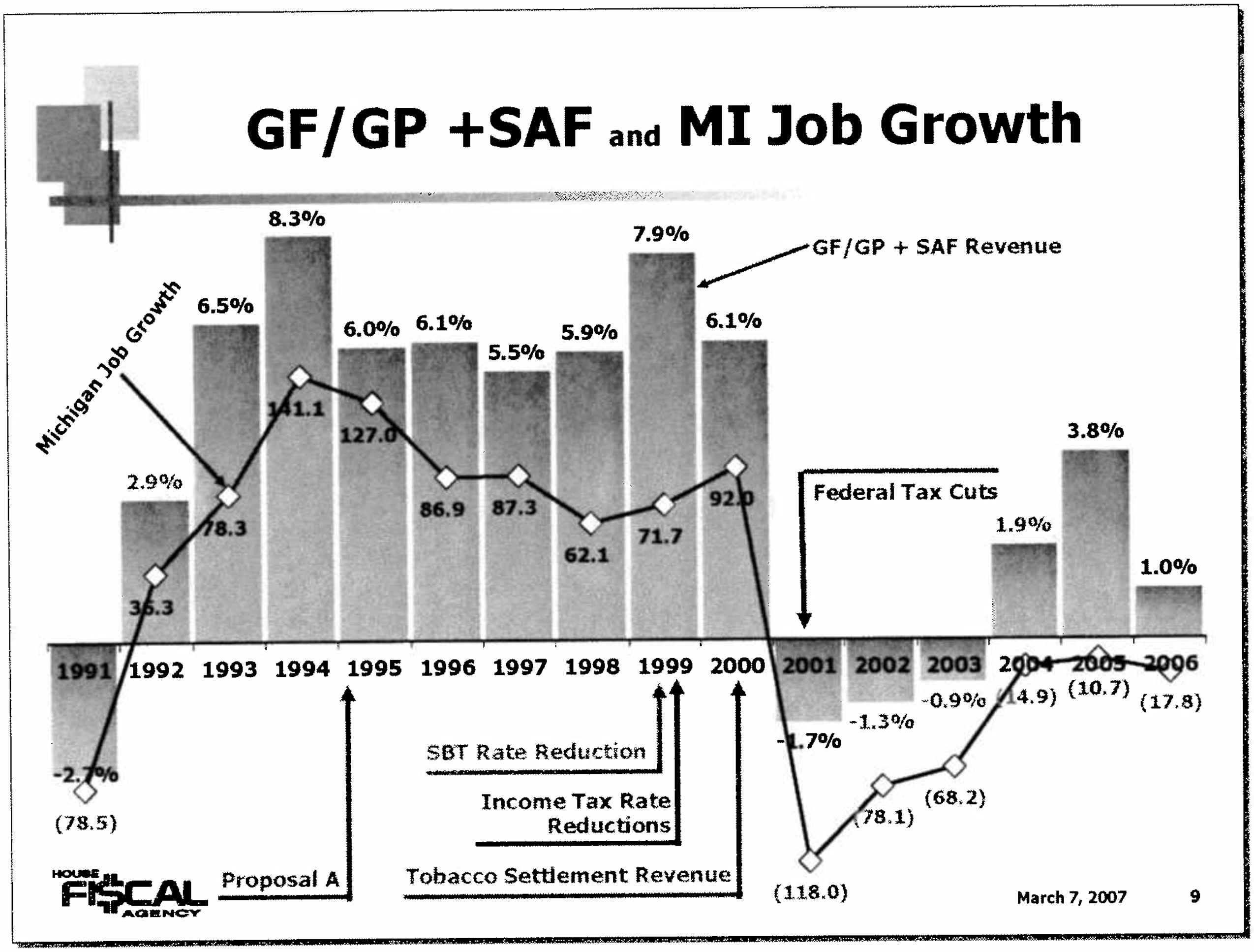
Revenue growth:

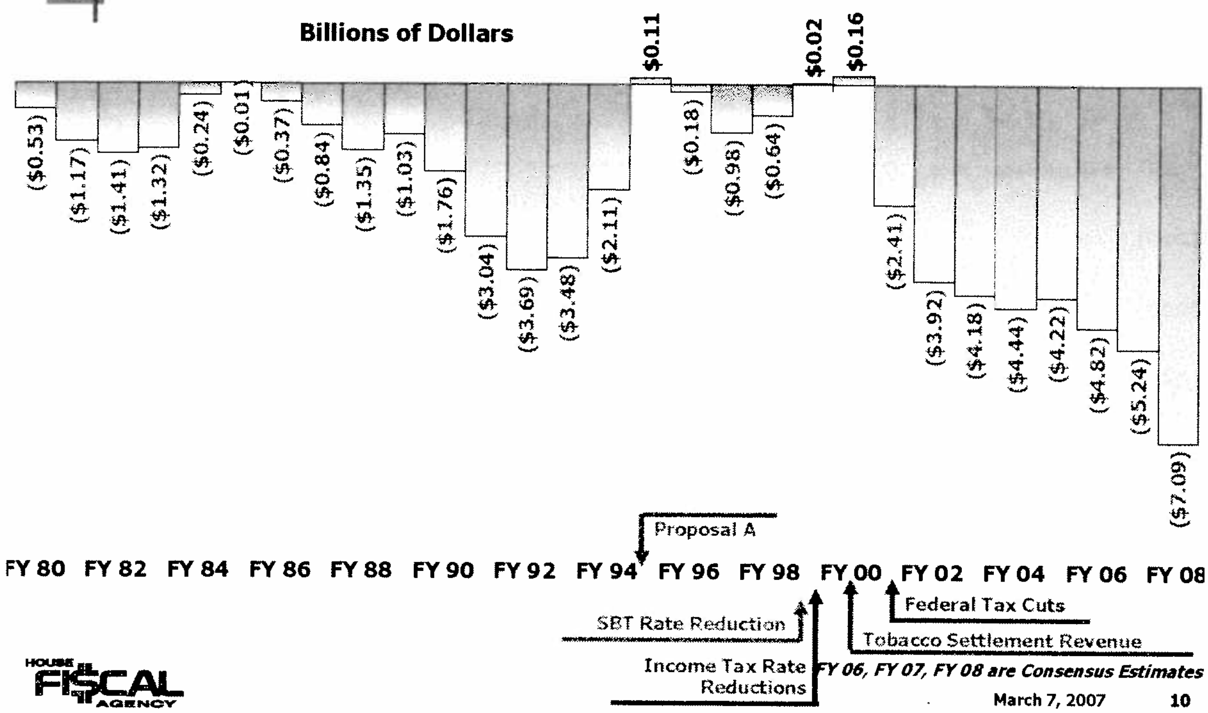
- **Strong coming out of recession (early 1990s)**
- **Slow by comparison since FY 99-00**



Important changes in state tax policy were

- **Preceded by strong revenue growth and**
- **The potential for violating state revenue limit**

Constitutional Revenue Limit



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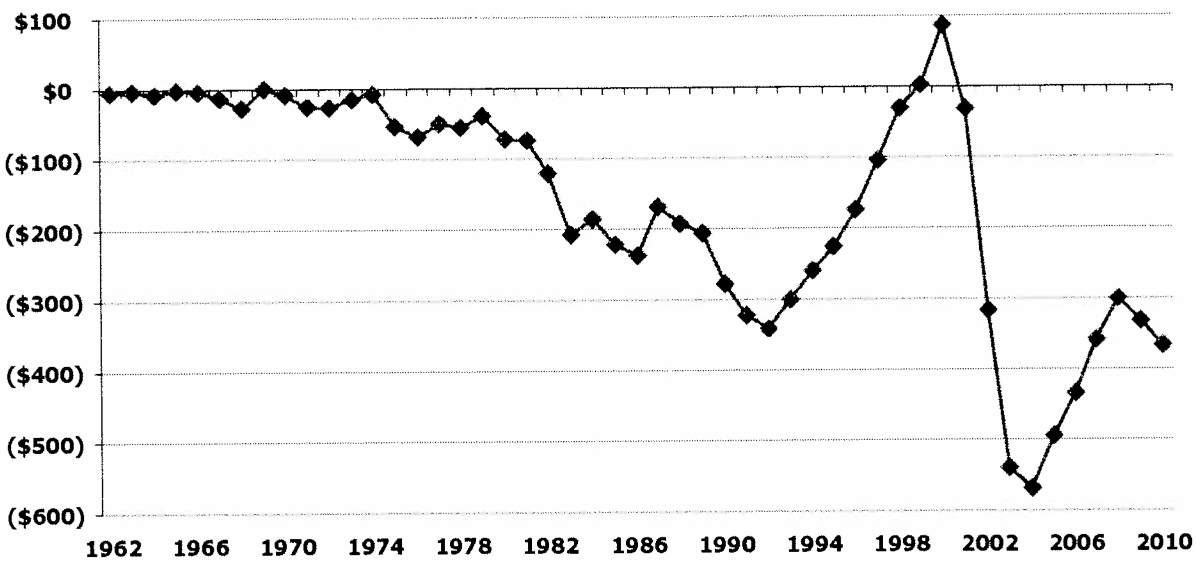
Revenue limit:

- **Calculation measures size of state government piece of the state economy**
- **State government share down $5 billion in 2006**

Federal On-Budget Deficit

Billions of Dollars



Note: 2007 through 2010 are projections

Source: Congressional Budget Office, Office of Management and Budget

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National economy stimulated by:

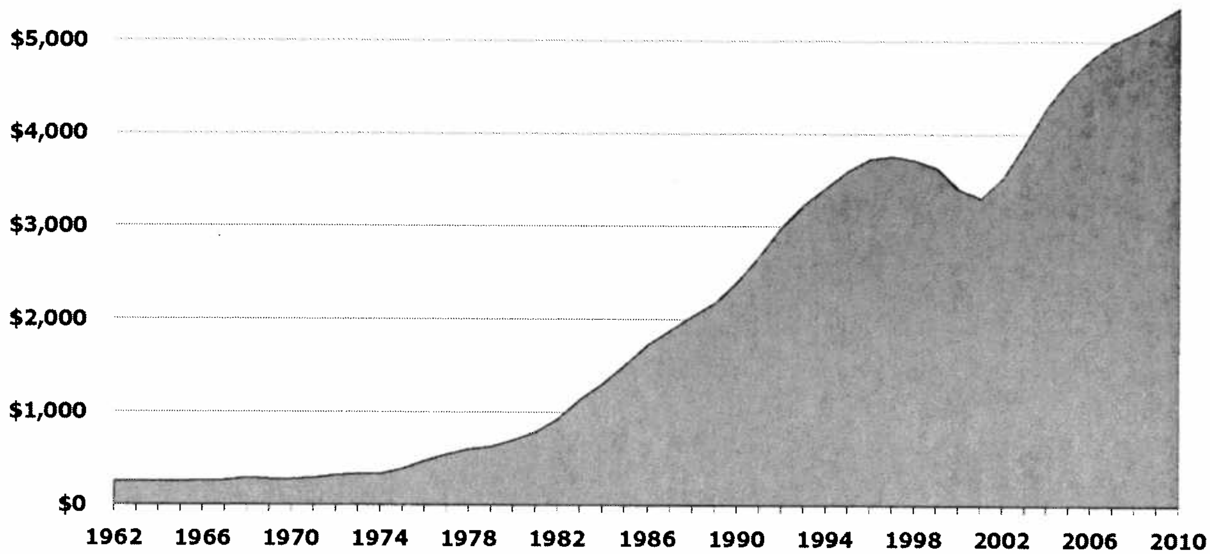
- **Federal tax cuts**
- **Federal government spending**

Deficit spending increases:

- **Demand for goods/services in private sector**
- **Demand for labor**

Federal Publicly-Held Debt

Billions of Dollars



Notes: Does not include borrowing from Social Security Trust Fund; 2007 through 2010 are projections
Source: Congressional Budget Office, Office of Management and Budget

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Tax cuts + deficit spending leads to debt

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Summary

"How much of an impact did state tax policy have on the strong job growth of the 1990s?"

Precise measure cannot be made, but there was some impact.

"How much impact is state tax policy likely to have on job growth as we move forward?"

Current state economic problems and lack of job growth have little to do with taxes.

Tax policy alone will not solve state's economic problems.

An advanced capitalist economy requires infrastructure, an educated workforce, public safety, a court system, a proper regulatory environment, and an appropriate social safety net to function—state government is instrumental to each one of these areas.

EXECUTIVE RECOMMENDATION
FY 2006-07 and FY 2007-08 REVENUE CHANGES

The Executive Recommendation for FY 2007-08 (and FY 2006-07 for some revenue items) includes the following changes:

- SBT replacement
- 2% excise tax on services
- Decoupling from the federal estate tax
- Elimination of various loopholes or tax expenditures
- Increases in the liquor markup and tobacco products tax
- Sales tax cut on the difference of the price of a new vehicle and the value of the trade-in vehicle
- Expansion of Club Keno games

These proposed changes are described below; the table that follows indicates which funds would be affected.

Single Business Tax (SBT) Replacement

The Michigan Business Tax (MBT) would replace the SBT. The MBT would be a broad-based business tax with a 0.125% tax rate on gross receipts, assets, and weighted profits. It maintains the $350,000 gross receipts filing threshold that exists in the SBT, and softens the $350,000 cliff that exists with the current SBT by phasing in the rate between $350,000 and $700,000 of gross receipts. Insurance firms would continue to pay the insurance premiums tax, but at a higher 1.25% rate.

The proposal would also eliminate the 6-mill State Education Tax and 18-mill non-homestead levy for industrial and commercial personal property, and retain existing SBT economic development credits (such as MEGA, Historic, Brownfield, and Renaissance Zone). In addition, two new credits would be created: the first would target large businesses that have their headquarters located in Michigan, and the second would provide a credit for research innovation up to $500,000 (matched by MEGA) used for small business research and development.

When considered in conjunction with the repeal of the SBT on December 1, 2007, the combined effect of these changes would provide a net tax reduction of $81.2 million in FY 2007-08. When compared with current law, the new MBT would increase revenue by an estimated $1,086.0 million in FY 2007-08.

2% Excise Tax on Services

A 2% tax would be levied on selected services such as:

- Professional entertainment
- Construction services

- Legal, accounting, and personal services
- Repair and maintenance services

The tax would not apply to such services as health care or education, daycare, religious services, sales to non-profit entities or state/local governments, high school or college sports admissions, or services currently taxed under the sales/use tax acts. Both consumers and businesses would be subject to the tax.

Should the excise tax become effective on June 1, 2007, as proposed, the tax would generate an estimated $477.0 million in FY 2006-07 and $1,473.9 million in FY 2007-08.

Decoupling From the Federal Estate Tax

Michigan would decouple from the federal estate tax, which is scheduled to sunset in 2010. The tax would apply to estates with a taxable value in excess of $2.0 million if the decedent's date of death is on or after April 1, 2007. Assets of family-owned businesses (including family farms) would be exempt in accordance with section 2057(e) of the IRS code. The Michigan Department of Treasury estimates that, on average, about 350 estates would be subject to the tax in any given year.

Because the estate tax return would not need to be filed until nine months after the date of death, the estate tax would not yield any revenue in FY 2006-07. This change would increase estate tax revenue by an estimated $119.2 million in FY 2007-08.

Elimination of Loopholes/Tax Expenditures

Telecommunications

International and certain interstate telecommunications (e.g., toll-free calls, WATTS lines, interstate private networks, and international calls) are currently exempt from the use tax. Making such telecommunications subject to the use tax would increase revenue by an estimate $7.4 million in FY 2006-07 and $22.8 million in FY 2007-08.

Interstate Trucks and Trailers

Purchases of trucks, trailers, and parts by interstate motor companies are exempt from sales and use taxes as long as at least 10% of the company's total mileage driven occurs outside of Michigan. Eliminating this condition would mean subjecting a percentage of these purchases to the same percentage as the number of miles driven in Michigan relative to total miles; that is, if 30% of the carrier's total miles are in Michigan, 30% of its previously exempt purchases would be taxable. This would increase sales/use tax revenue by an estimated $5.5 million in FY 2006-07 and $16.9 million in FY 2007-08.

Purchases Made by Department of Corrections Inmates

Under current law, purchases made by inmates at prison stores are exempt from the sales tax. Eliminating this exemption would increase sales tax revenue by an estimated $0.2 million in FY 2006-07 and $0.7 million in FY 2007-08.

Insurance Company Use Tax

Under current law, insurance companies pay a tax under the SBT that is "in lieu of other taxes except taxes on real and personal property." This "in lieu of" provision exempts insurance companies from the use tax on items purchased from out-of-state retailers and from the sales tax when they sell property at retail. Although the Executive Recommendation would subject the insurance companies to the sales and use tax, it would primarily be a use tax issue to eliminate the incentive for insurance companies to purchase tangible personal property from out of state. This change would increase use tax revenue by an estimated $1.2 million in FY 2006-07 and $3.7 million in FY 2007-08.

Oil and Gas Double Exemption
Oil and gas production are subject to a severance tax. As such, royalty income (which is taxable at the federal level) is subtracted from federal adjusted gross income (AGI) on the MI-1040, Schedule 1. Court rulings have permitted additional subtractions for certain indirect costs (such as depreciation) from the federal AGI—in essence, providing for a double exclusion. Eliminating the explicit subtraction on Schedule 1 would eliminate this double exemption and increase income tax revenue by an estimated $3.9 million in FY 2007-08.

Penalties and Interest
In 2002, penalties were reduced for taxpayers that fail to file a tax return, or pay a tax on time, or pay a tax with a check that bounces. Restoring penalties for late payments of certain income tax withholding, sales tax, and use tax generates an estimated $1.7 million in FY 2006-07 and $5.1 million in FY 2007-08.

Vended Food
Most food sold for immediate consumption is subject to the sales tax. Hot or cold foods dispensed from vending machines are also subject to the sales tax—except for some foods sold through vending machines (non-alcoholic beverages, milk, and food products at or near room temperature) which are specifically exempt. Eliminating this exemption to put vended foods on a par with other foods sold for immediate consumption would increase sales tax revenue by an estimated $8.8 million in FY 2006-07 and $27.2 million in FY 2007-08.

Water Softener Property Tax
Currently, water coolers and water softeners that are leased are exempt from the personal property tax. Eliminating this exemption would subject this property to the 6-mill State Education Tax (SET) as well as the 18-mill non-homestead millage. The 6-mill SET would directly increase the SAF; the 18-mill non-homestead millage would be dedicated to pupil funding at the local level. This change would result in an estimated $0.3 million increase in revenue in FY 2007-08.

Affiliate Nexus for Use Tax
The recommendation is to create "affiliate nexus" standard for nonresident affiliates. Nexus, an economic presence within the state that establishes tax liability, is established by certain business activities or real and tangible personal property held in the state. The "affiliate nexus" standard would disregard the legal business form in opposing nexus for nonresident affiliate companies without a physical presence in Michigan. This change attempts to take into account business activities of businesses that have a close connection (for example: XYZ company and XYZ.com). This change would increase use tax revenue by an estimated $1.2 million in FY 2006-07 and $3.6 million in FY 2007-08.

WPW Fix
A 2002 Michigan Supreme Court decision (*WPW Acquisition v City of Troy*) barred the implementation of Proposal A (School Finance Reform) legislation regarding property taxation on commercial rental property. The Michigan Supreme Court ruled that an increase in value

due to an increase in a commercial rental property's occupancy could not be used to increase the property's taxable value beyond the constitutional assessment cap established by Proposal A. As a result of this decision, commercial rental property taxes are based on occupancy decreases and are not adjusted upward if the property's occupancy rate increases. The Executive proposal would remove commercial rental property from the General Property Tax Act and create a new specific tax that generates a FY 2007-08 estimated savings of $5.0 million.

Increase Liquor Markup

The Michigan Liquor Control Commission (MLCC) is the wholesaler of all spirits in Michigan. The MLCC currently sells liquor with a 65% markup (which is approximately 20% of the retail price) prior to selling to licensees. Profits from the sale of liquor are transferred to the General Fund. The Executive Recommendation would increase the liquor markup to 75%. This change would increase revenue by an estimated $8.8 million in FY 2006-07 and $27.1 million in FY 2007-08.

Increase Tobacco Products Tax

The current tax on cigarettes is $2.00 per pack; the tax rate on other tobacco products (OTP) is 32% of the wholesale price. The Executive Recommendation would increase the cigarette tax by 5 cents per pack and would double the OTP tax. This change would increase revenue by an estimated $18.1 million ($8.5 million from cigarettes and $9.6 million from OTP) in FY 2006-07 and $57.6 million ($21.0 million from cigarettes and $36.6 million from OTP) in FY 2007-08.

Sales Tax on the Difference

Michigan is one of only a few states that allow no trade-in allowance for the purchase of new vehicles. The Executive Recommendation would allow a trade-in allowance for new vehicle purchases at dealers that sell new vehicles. This change would decrease sales tax revenue by an estimated $175.1 million in FY 2007-08.

Lottery

State Lottery is expected to expand the Club Keno game to pre-existing private organizations. It is estimated that the expansion of the game would generate $7.5 million in FY 2006-07 and $15.0 million in FY 2007-08.

EXECUTIVE RECOMMENDATION
FY 2006-07 and FY 2007-08 REVENUE CHANGES
(Millions of Dollars)

	FY 2006-07					FY 2007-08				
	GF/GP	SAF	MBTF	Other	Total	GF/GP	SAF	MBTF	Other	Total
Michigan Business Tax (MBT)						$1,249.4				$1,249.4
24-mill Exemption (Commercial/Industrial Property)							($203.4)			($203.4)
1.25% Tax on Insurance Premiums						$40.0				$40.0
2% Excise Tax on Services	$306.7	$170.3			$477.0	$750.2	$580.7	$143.0		$1,473.9
Decoupling from the Federal Estate Tax							$119.2			$119.2
Elimination of Loopholes/Tax Expenditures	$14.2	$11.7			$25.9	$40.0	$37.4		$6.8	$84.2
WPW Fix							$5.0			$5.0
Increase Liquor Markup	($0.2)	$9.2		($0.2)	$8.8	($0.6)	$28.3		($0.6)	$27.1
Increase Tobacco Products Tax			$18.1		$18.1			$57.6		$57.6
Sales Tax on the Difference						($15.0)	($128.3)		($31.8)	($175.1)
Lottery		$7.5	$0.0		$7.5		$15.0			$15.0
Total	**$320.7**	**$198.7**	**$18.1**	**($0.2)**	**$537.3**	**$2,064.0**	**$453.9**	**$200.6**	**($25.6)**	**$2,692.9**

*Notes: 1) **MBTF** is the Medicaid Benefits Trust Fund; **Other** is revenue sharing for sales tax changes and the Convention Facility Development Fund for the liquor changes. 2) First three items are key components for proposed SBT replacement.*

Single Business Tax Replacement/Modification Proposals

The Single Business Tax (SBT), which is estimated to generate almost $1.9 billion of revenue in FY 2006-07, is scheduled to be repealed at the end of 2007. The SBT is a broad-based value added tax. Because it is broader than a corporate income tax, it applies to almost all types of business entities (such as C-Corporations, S-Corporations, Limited Liability Corporations (LLCs), and partnerships). Firms with less than $350,000 in apportioned gross receipts are exempt from the SBT.

All SBT revenue accrues to the General Fund, which is estimated to total about $8.4 billion in FY 2006-07. Because the SBT accounts for almost 23% of General Fund revenue, several alternative proposals have been advanced.

The only tax plans that have actually been introduced in bill form are the Michigan Business Tax (MBT), which has been proposed by the Governor, and the Business Economic and Stimulus Tax (BEST), proposed by the Senate Republicans. The remaining proposals have been advanced by various organizations, but have not been officially introduced. The details of many of these plans have been subject to periodic revision, and it is likely that some of the provisions will continue to change as they are further refined.

Michigan Business Tax

The Michigan Business Tax (MBT) imposes a 0.125% tax rate on a broad base comprised of gross receipts, assets, and profits. While maintaining the $350,000 gross receipts filing threshold that exists in the SBT, the MBT softens the $350,000 cliff that exists with the current SBT by phasing in the rate between $350,000 and $700,000 of gross receipts.

The proposal would also eliminate the 6-mill State Education Tax and 18-mill non-homestead levy for industrial and commercial personal property, and retain existing SBT economic development credits (such as MEGA, Historic, Brownfield, and Renaissance Zone). In addition, two new credits would be created: the first would target large businesses that have their headquarters located in Michigan, and the second would provide a credit for research innovation up to $500,000 (matched by MEGA) used for small business research and development.

Business Economic and Stimulus Tax

The Business Economic and Stimulus Tax (BEST), which is comprised of two separate taxes. The first has a base composed of gross receipts less purchases from other firms, and business assets less liabilities. Taxpayers would have some flexibility in choosing the weighting factors on the two components. The rate would be determined by the Michigan Department of Treasury.

The second tax is a business income tax that builds off the federal definition of business income with a rate of 1.2%. All businesses with more than $15 million in gross receipts would be subject to the tax; those with less than $350,000 in gross receipts would be exempt. Firms with gross receipts between $350,000 and $15 million could choose to pay either one of the two taxes.

The combined revenue from the two taxes is designed to equal $1.56 billion. In the event that revenue exceeded this amount by more than the rate of inflation plus one percent (as measured by the Detroit Consumer Price Index), the tax rate would be reduced in the following year so that the combined revenue would again equal $1.56 billion, adjusted for inflation plus one percent.

Detroit Chamber of Commerce Proposal

The Detroit Chamber has proposed a "Business License Fee," which is essentially a gross receipts tax. Like the current SBT, it would not be restricted to just C-Corporations. In addition, a business with less than $350,000 in gross receipts would incur no tax liability. Businesses with gross receipts in excess of $350,000 would pay the license fee according to the following schedule:

Gross Receipts Range			License Fee	Gross Receipts Range			License Fee
$350,001	to	$500,000	$1,000	$30,000,001	to	$40,000,000	$75,000
$500,001	to	$750,000	$2,000	$40,000,001	to	$50,000,000	$100,000
$750,001	to	$1,000,000	$2,500	$50,000,001	to	$60,000,000	$150,000
$1,000,001	to	$2,500,000	$5,000	$60,000,001	to	$70,000,000	$200,000
$2,500,001	to	$5,000,000	$7,500	$70,000,001	to	$80,000,000	$250,000
$5,000,001	to	$10,000,000	$15,000	$80,000,001	to	$90,000,000	$300,000
$10,000,001	to	$20,000,000	$30,000	$90,000,001	to	$100,000,000	$500,000
$20,000,001	to	$30,000,000	$50,000	$100,000,001		and over	$1,000,000

One of the drawbacks of this type of structure is the 16 different brackets and the corresponding cliffs. For example, a business with $1 million in gross receipts would pay a license fee of $2,500 (0.25%). However, if the firm realizes just one additional dollar of gross receipts, its tax liability would increase to $5,000.

Although no specific details have been provided, the Detroit Chamber has indicated that it also supports providing some form of relief from the Personal Property Tax, which is estimated to total almost $1.8 billion in FY 2006-07. Based on data from the 2000 tax year, the Business License Fee would reduce revenue by approximately $500 million.

Grand Rapids Chamber of Commerce Proposal

The Grand Rapids Chamber is proposing a modified gross receipts tax called the Michigan Business Activity Tax (MBAT). Although it would apply to the same types of firms as the SBT and the Detroit Chamber proposal, it would impose a $150 minimum tax on firms with less than $350,000 in gross receipts. Sole proprietorships with no employees would be exempt.

The base for the MBAT would be Michigan revenue from sales of goods and services less the cost of tangible personal property for resale, manufacturing, leasing, or the cost of funds for financial institutions. The base would be subject to a single rate which would not exceed 0.75%, and which would also generate an amount of revenue no larger than 90% of current SBT, insurance company premiums tax, and personal property tax revenue. Because these three taxes are estimated to generate in excess of $3.9 billion in FY 2006-07, the MBAT would reduce state and local revenue by almost $400 million. A provision of the MBAT would hold local units of government harmless for the loss of personal property tax revenue.

Michigan Chamber of Commerce Proposal

The Michigan Chamber has proposed two alternatives, each of which is a combination of a business income and gross receipts tax. Unlike the Detroit Chamber proposal, the gross receipts component would have a flat rate for all firms, although wholesale and retail trade entities would be subject to a lower rate than other businesses. Firms with less than $350,000 of gross receipts would be exempt from the gross receipts component, but would still be subject to the business income tax. All firms would pay a minimum of $150. The rates would be set to provide a net revenue reduction of approximately $500 million. In addition, approximately 75% of the revenue would come from the gross receipts component; the remaining 25% would come from the business income tax.

The second alternative is essentially the same except that it also provides a 50% credit against personal property taxes paid by a firm. As a result, the gross receipts and business income tax rates are higher so that the $500 million revenue reduction remains the same.

Wolfram Proposal

Like the Michigan Chamber approach, this approach actually consists of two separate taxes. Unlike the Michigan Chamber's proposal, however, a business could choose file using either of the two methods. The primary tax would essentially be a modified value added tax with a single tax rate of approximately 0.75%, although a business could instead choose to pay an income-based tax with a 6% (approximate) rate. The combined impact from the two options would result in a net revenue reduction of about $100 million, with the potential for additional reductions in subsequent years.

Single Business Tax Replacement/Modification Proposals

	Basic Structure	Tax Rate(s)	Maximum Tax	Firms with less than $350,000 in gross receipts	Personal Property Tax	Estimated Revenue Impact
Governor's Proposal: Michigan Business Tax	Combination of gross receipts, assets, and profits	0.125%	None	$0	Eliminates 6-mill State Education Tax and 18-mill non-homestead levy for industrial and commercial personal property	$475 million reduction
Business Economic and Stimulus Tax	Combination of gross receipts, franchise, and business income	Determined by Department of Treasury Business income: 1.2%	None	$100 for firms with gross receipts greater than $100,000	Exempts new industrial personal property	$350 million reduction
Detroit Chamber Proposal	Gross receipts tax	16 brackets	$1 million	$0	No specific treatment	$500 million reduction
Grand Rapids Chamber Proposal	Modified gross receipt tax	Maximum 0.75%	None	$150	Eliminate PPT and replace revenue to hold local units of government harmless	$400 million reduction
Michigan Chamber Proposal	Combination of gross receipts and business income taxes	Gross receipts: 0.24%/0.18% Business income: 1.85%	$2 million	$150	One option would provide a 50% credit for personal property taxes, but impose higher rates to offset additional revenue reduction.	$500 million reduction
Wolfram Proposal	Option of either business income or modified value added tax at taxpayer's discretion	Modified value added: 0.75% Business income: 6.0%	No specific treatment	No specific treatment	No specific treatment	$100 million reduction

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